Firms' Voluntary Disclosure Strategies:

The Presentation and Disclosure of Derivative Financial Instruments

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The work presented in this thesis is, to the best of my knowledge and belief, original except as acknowledged in the text. The material has not been submitted, either in whole or in part, for a degree at this or any other university.

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ABSTRACT

Until reporting periods ending on or after 31 December 1997, disclosure of financial instruments was unregulated in Australia. This thesis examines motivating factors for Australian firms' voluntary derivative instrument disclosures during the unregulated reporting regime spanning 1992-1997. It proposes that managers' disclosure strategies are a consequence of explicit and implicit contractual arrangements aimed at protecting and enhancing individuals' and firms' financial reporting reputations and maximising firm value.

Aims

Financial statement preparers' preferences can be revealed through voluntary reporting practices and/or lobbying activity. By investigating firms' voluntary disclosure practices in response to proposed accounting regulation and professional requirements, this study contributes to understanding cost/benefit tradeoffs with respect to information disclosures. Specifically, the thesis examines two dimensions of voluntary derivative instrument disclosures. The first dimension focuses on predicting the degree to which Australian firms comply with the disclosure requirements contained in an exposure draft (ED65) and an Industry Statement issued by Australian accounting standard setting bodies and the Australian Society of Corporate Treasurers (ASCT) respectively. The thesis examines disclosures longitudinally, transcending reporting periods where the disclosures are purely voluntary to periods where coercive pressure is exerted on firms for transparency in relation to their derivative instrument activities. It tests whether changes in derivative disclosures across the different reporting regimes are significantly associated with changes in disclosure pronouncements. The thesis then tests for systematic differences in the characteristics of high and low disclosure firms. The tests use variables grounded in costly contracting theory as well as variables developed using a legitimacy framework. This extends the extant literature by: (a) simultaneously applying these alternate frameworks; and (b) applying legitimacy theory to a financial reporting issue, as distinct from a social or environmental issue.

Specifically, the research questions addressed in this study are:

(1) Why, and to what degree, do Australian entities voluntarily comply with the derivative financial instrument disclosure requirements contained in ED65 and the ASCT Industry Statement?

(2) Are there any systematic differences in the characteristics of entities with high disclosure compliance *versus* low disclosure compliance in relation to derivative financial instruments?

Scope

The thesis studies the voluntary disclosure responses of Australian financial statement preparers to derivative financial instrument disclosure requirements proposed by ED65 and the ASCT Industry Statement. Given that regulation governing derivative instrument disclosures did not become effective until reporting dates on or after 31 December 1997, this thesis studies voluntary disclosures in firms' 1992-1997 annual reports. Using a self-constructed disclosure index, firms are assigned an integer score determined by the presence/absence in their annual report of a range of derivative financial instrument information. The information score relates to policy, risk, and net market value disclosures.

Conclusions

A change in the number and quality of derivative financial disclosures during 1992-1997 reporting periods is evident. Early 1990s derivative financial instrument disclosures are more likely to be by large firms or firms in the extractive industry. The disclosures increase significantly in 1995, coinciding with the period when the ASCT Industry Statement and exposure draft are issued. This suggests that managers reassess derivative financial instrument disclosure strategies in line with the increased probability of mandated disclosure requirements and the pressure on financial statement preparers to be professionally responsible. Firms subject to public scrutiny and firms with professional affiliations with the body issuing the industry statement and the Group of 100 companies are particularly responsive to the demand for derivative instrument activity transparency. Apart from firm leverage, variables grounded in costly

contracting theory are generally not significant predictors of derivative financial instrument disclosures.

This study is significant in that the results highlight the potential for professional organisations, other than the accounting profession, to influence the content of financial information contained in annual reports. This is an important consideration for accounting regulators. It indicates the need of regulators to respond in a timely manner to financial accounting issues in order to maintain their credibility and legitimacy. Whilst other interpretations may be possible, the findings also highlight the importance managers attach to firms' derivative financial instrument disclosures as a means of personal and corporate reputation and legitimacy maintenance and enhancement. Furthermore, the study introduces firm attributes that are new to financial accounting disclosure choice studies and in doing so demonstrates the benefits of simultaneously applying alternative paradigms to voluntary reporting issues.

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